Big fall on Wall Street as mortgage debt problems grow

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US share markets fell sharply on Tuesday amid fears that the collapse of the biggest independent sub-prime mortgage lender and problems in the mortgage industry and housing market could spread through the banking and financial system.

The Dow Jones index fell 242 points, just below 2 percent, and the Nasdaq dropped by more than 2 percent following reports on Monday that New Century Financial may go into bankruptcy with $8.4 billion worth of debts that could come due immediately. Trading in the company's shares was halted by the New York Stock Exchange after it revealed that banks had either cut off credit or intended to do so.

The demise of New Century, which reported $25.1 billion worth of assets last September, is a significant event in itself. But its impact has been amplified because it reflects wider problems in the entire mortgage and housing market.

Data released by the Mortgage Bankers Association (MBA) for the last three months of 2006 showed that late or missed payments on mortgages rose to 4.95 percent, rising to 14.4 percent in the so-called sub-prime market, in which loans are issued to borrowers considered a greater credit risk. The figures were the highest in the 37-year history of the MBA's delinquency survey and there are fears the situation is worsening.

According to a research note issued by analysts at Lehman Brothers, if home prices remain flat this year and next, mortgage defaults could total $225 billion, creating a risk of pulling down the entire housing market. Lenders in the sub-prime market made $640 billion in mortgage loans last year, around one fifth of the total mortgage market, and almost double the amount in 2003.

Hardest hit in the market downdraft were sub-prime lenders with Accredited Home Lenders losing 65 percent, having lost 28 percent on Monday, following an announcement that it may have to raise extra funds, seek debt waivers and cut jobs.

Even more significant was the impact on the banks which have become heavily involved in the mortgage debt market during the recent housing bubble. Some of the biggest names in US and world banking are involved.

Apart from Bear Stearns, with which it has a "longstanding" relationship to finance its mortgage operations, New Century revealed that it had dealings with Bank of America, Citigroup, Credit Suisse, Goldman Sachs and Morgan Stanley.

Bear Stearns suffered its biggest fall since September 2001, leading the declines among the 88 financial stocks in the S&P 500 index. Shares in Goldman Sachs, the world's largest securities firm by market value, fell even after it reported 34 percent more profit than market analysts had predicted.

The market fall, following the global rout of two weeks ago, has raised concerns about the state of the US economy as a whole. "If this really does turn into a nasty downturn in housing, no one really knows what the implications for the economy will be," Kevin Bannon, the chief investment officer at the Bank of New York told Bloomberg News agency. "These things basically raise concern about whether we're slipping into a recession."

The chief concern at this point is the impact of the downturn in the sub-prime mortgage market on the major finance houses. As an article in Tuesday's *Wall Street Journal* noted: "For years, an obscure class of Wall Street investment vehicles has acted like a locomotive in the housing-finance business, driving growth by soaking up risky mortgage bonds and parceling them out to investors around the world.

"Now, as mortgage problems mount and a wave of mortgage-bond downgrades looms, these investments, known as collateralized debt obligations [CDOs], are starting to look like a different vehicle—rockets overloaded with combustible fuel."

CDOs are part of what the article called Wall Street's "mortgage dicing and slicing machine." After mortgages are taken out, investment banks then pool them and then issue them as mortgaged-backed bonds. These bonds can also be pooled together and sold off in slices with investors getting to choose the level of risk. Last year, Deutsche Bank estimated that CDOs accounted for $150 billion worth of mortgage backed bonds, most of which were underpinned by sub-prime mortgages.

But these sub-prime mortgages have become increasingly risky. In 2000 the average loan to a sub-prime borrower was 48 percent of the property value. By 2006 that figure had risen to 82 percent.

However, even as the risk increased, finance houses continued to profit as long as the housing bubble kept growing because the sale of a house as a result of any default would cover the outstanding debt. Now prices have turned down as defaults are increasing.

The big firms in the business have been Lehman Brothers, Bear Stearns, Merrill Lynch, Morgan Stanley, Deutsche Bank and UBS. According to a report in Sunday's *New York Times*: "The profits from packaging these securities and trading them for customers and their own accounts have been phenomenal. At Lehman Brothers, for example, mortgage-related businesses contributed directly to record revenue and income over the last three years."

There are two interconnected aspects to the problems in the mortgage market. In the first instance, rising defaults could see more houses coming on the market in forced sales, leading to a further decline in prices. Given the role of the housing bubble in sustaining consumer spending in recent years, a slump in the housing market could spread to the US economy as a whole.

Then there are the implications for financial markets. If the collapse of New Century Financial leads to further bankruptcies of sub-prime mortgage lenders, the financial impact will extend more broadly. While securities backed by home mortgages have been around for more than three decades, it is only in the past five years or so that major investors such as pension funds, insurance funds and hedge funds have moved into them so heavily.

As the *New York Times* commented, while "investment manias are nothing new" the "demise of this one has been broadly viewed as troubling, as it involved the nation's $65 trillion mortgages securities market, which is even larger than the United States treasury market."